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AN EXAMINATION OF SHAREHOLDERS PERCEPTION ON MANDATORY AUDIT ROTATION IN NIGERIA

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ABSTRACT

We investigated the perception of shareholders on mandatory audit rotation in Nigeria. This became necessary following the directive of the Central Bank of Nigeria in 2009 that all banks should rotate her external auditors after ten years of engagement. Questionnaires were distributed to investors. The study made use of tables, percentages and regression analysis. The study observed a negative relationship between Mandatory Audit Rotation (MAT) and shareholders' confidence. This implies that the rotation of external auditors does not boost the confidence of shareholders in Nigeria. The study recommended that mandatory rotation of external auditors in Nigeria be revisited. The benefit can only be a perception and not a reality while the cost both implicit and explicit does not favour the very shareholders whom the policy seeks to protect.

KEYWORDS: Mandatory Audit Rotation, Shareholders Confidence

INTRODUCTION

As a result of the separation of ownership from management, shareholders engage the services of external auditors to audit the accounts prepared by the directors in order to ascertain the reliability of the financial statement of the company. Abbott, Parker, Peter and Raghunandan (2003) agree that the demand for auditing stems from a desire to reduce managements skirting, resulting from information asymmetries, which arises from the separation of ownership and control. Ojo (2009) added that the involvement of external auditors contribute to addressing the expressed agency problem, as the auditor can facilitate a situation where by managers are encouraged and also compelled to be held accountable. The opinion of the external auditors adds credibility to the financial statement since the external auditor is an independent examiner of the financial statements of an enterprise prepared by the management of that enterprise. Furthermore, the responsibility of the external auditors is to express a professional opinion whether or not those financial statements show a true and fair view position of the enterprise as at the end of the financial period in accordance with the auditor's terms of engagement as well as other relevant statutory and professional regulations. Audited financial statement reduces risk premiums, assists prospective and existing investors in making an informed decision.

However, the recent high-profile misstatements and fraud by large corporations have brought increased scrutiny of the role that external auditors play in the financial statement certification. Corporate scandals, across the globe have raised shareholders and research interests on the reputation and objectivity of the external auditors. For instance Enron filed in for bankruptcy after receiving a clean report from one of the then leading BIG4 auditing firm in US: Arthur Andersen in 2002. Mandatory audit firm rotation of external auditors have been suggested as a means of reducing the large scale corporate collapses, fraud, familiarity threat and also increase shareholders confidence (Healey & Kim, 2003; Francis, 2004; Hyeeso, 2004; Firth, Rui & Wu, 2010). This paper therefore examines shareholders perception on mandatory audit rotation in Nigeria. This became necessary following the directive of the Central bank of Nigeria in 2009

that all banks should rotate her external auditors after ten years of engagement.

The study will add to the existing body of knowledge as it thrust auditors to brace up to the sacred responsibility posed on them as a watchdog to the shareholders. It will also assist regulatory bodies and government authorities in policy making and monitoring, while serving as a source of reference to academics and researchers. Accordingly the paper is organized as follows: section one introduces the subject matter; following our introduction, section two looks at the findings of existing literatures while section three discusses the data, the model and the variables employed in our study. Section four provides the result of our empirical analysis while section five presents the conclusion.

REVIEW OF RELEVANT LITERATURES

Theoretical Framework

Agency theory is one of the oldest theories of auditing. Agency relationship arises when one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent (Jensen & Meckling, 1976, Ross, 1973). The bedrock of agency theory is the assumption that the interest of principle and agents diverge. This arises mainly as a result of the separation of ownership and control, which result in many instances to firm managers using their firm-specific knowledge and managerial expertise to gain an advantage over the firm’s owners, who are absent from the day-to-day management of the firm. Since management is different from owners, information asymmetry is bound to occur where the owners may not completely know what the agents are doing. For the owners to believe the stewardship accounts rendered by the managers they engage the service of an external auditor(s) to examine the account of the company. The report of the auditor lends credence to the owners in making their decisions.

Conceptual Frame Work

The concept of mandatory audit rotation came in as a result of highly publicised corporate failures that resulted in litigations (Zawawi, 2007). Mandatory rotation of audit firm is the statutory prescription of the length of time an audit firm stays and renders professional services to her clients before being rotated despite the efficiency, quality of services rendered, trust and the willingness of the shareholders to keep the audit firm (Onwuchekwa, Erah & Izedonmi, 2012). Asein (2007) recorded that rotation of external auditors was conceived to be a solution to possible familiarity threat between personnel of the audit firm and the clients. This is as a result of the high premium placed upon audited financial statement which makes regulators to constantly look for ways to enhance the quality of the audit through auditor independence, objectivity and professional skepticism. The Bocconi School of Management (2002) opines that auditors carry out two valuable roles for capital market participants: an information role and an insurance role. They give an independent verification of the financial statements prepared by managers and can prevent conflict of interests between managers and shareholders, thus enhancing the value of companies. When auditors find that some information has not been disclosed or has been manipulated, they issue a qualified report. The public announcement of a qualified opinion would impact negatively on share prices. In this situation, managers would be removed by shareholders and the conflict of interests resolved, with a new team appointed. When the auditor and managers are closely related, familiarity threat creeps in. The consequence of this situation would endanger the independence of auditors who could give a biased opinion and of managers who could dismiss good auditors to avoid a qualified opinion or use their influence to manipulate it. The final outcome of this conflict is an increase in the monitoring costs and information costs, which result in a higher cost of capital for the firm, thus limiting its potential to raise financial capital. If both auditors and managers lack the quality of independence, and if financial markets are not efficient enough to react and signal to shareholders that incumbent managers should be removed, a way to solve the problem and ensure that auditors really monitor management behaviour would be

the imposition of audit rotation after a certain period of mandate.

The rotation would ensure that if the incumbent auditor is opportunistically acting against the shareholders' interest, the newly appointed auditor would re-state the required independence. The new appointment would therefore signal to the market that the quality of the information is higher.

Empirical Finding

Investors' perceptions of external auditors are important, as such perceptions can in turn affect their confidence related to the reliability of financial statements; investor confidence is a necessary underpinning for strong and vibrant capital markets. Ghosh and Moon (2005) took an analysis of investors and intermediaries' perception on audit tenure. A basic regression model was developed to discover whether investors, rating agencies and financial analysts perceive earnings quality as being affected by tenure. The results provide limited evidence that independent rating agencies view long auditor tenure as having a favourable impact on earnings quality. Moody, Pany and Reckers (2006) find that mandatory audit firm rotation enhances auditor independence perceptions compared to partner rotation. Arel, Brody and Pany (2006) document that auditors in the rotation condition are more likely to modify their audit report as opposed to those in a situation where a continuing relationship is expected. Gates, Lowe and Reckers (2007) sampling the opinion of seventy nine Masters in Business Administration students in USA, recorded that audit firm rotation incrementally influence individual's confidence in financial statements, whereas audit partner rotation does not have a similar effect. Kaplan and Mauldin (2008) find that audit firm rotation does not strengthen 'independence in appearance' among investors. Copley and Doucet (1993) observed that the likelihood of receiving a substandard quality audit increases with the length of the auditor-client relationship. O'Leary and Radich (1996) in Australia sampled the opinion of 300 companies and 180 audit partners, the study find that 63% of public listed companies and 37% of auditors consider mandatory audit firm rotation as a useful means of improving the perception of independence. Hussey and Lan, (2001) recorded that the perception of audit independence would be enhanced by prescribing the rotation of auditors even if the concerns about audit quality and costs are predominant and overall opinion on the rotation rule is negative. Our hypothesis is formulated in null form.

Ho: Mandatory audit rotation has no significant influence on shareholders' perception in Nigeria.

METHODOLOGY

We examined the perception of shareholders on mandatory audit rotation in Nigeria. The researchers made use of questionnaires to elicit information. Five hundred questionnaires were administered to three states in the southern part of Nigeria out of which four hundred and forty two were returned. After sorting and collating the data, the respondents appropriate option ticked were analyzed using tables and percentages. The model specified was estimated using the ordered logistic regression technique with the aid of computer software Eviews 7.

Model Specification

$$SHPERC = A_O + A_1MAR + \epsilon_t \qquad \text{(i)}$$

Where:	Ao,	=	Constant
	A_1	=	Parameter estimate
	MAT	=	Mandatory Audit Tenure
	SHPERC	=	Shareholder Perception

Et = Stochastic error term

The model specified above captured shareholders perception as the dependent variables while Mandatory audit tenure is the independent variable.

DATA PRESENTATION AND ANALYSIS

Analysis of Results

The hypothesis formulated previously is tested in this section. We accept the null hypothesis if the calculated Z-statistic is less than the Z-critical statistic. The Z-critical statistic is ± 1.96 at 5% significant level (95% confidence) otherwise we reject.

Test of Hypothesis

Hypothesis Formulation: The hypothesis formulated is restated

Ho: Mandatory audit rotation has no significant influence on shareholders' confidence in Nigeria.

Test Statistics: the statistic instrument employed in testing this statistic is the Z-test. The Z calculated value is –0.44 (see appendix I).

Decision: Following our decision rule. The regression result shows that MAT with a calculated Z-value of -0.44 is less than the critical Z-value of ± 1.96 at 5% level. Therefore, we accept the null hypothesis and declare that mandatory audit rotation has no significant influence on shareholders' confidence.

INSERT TABLE

Table 1 below explains respondents' views on mandatory audit tenure and shareholders perception. A total of 96 respondents representing 21.7 Disagree that a change of audit firm after a period of mandate would be perceived by the market as an improvement in the firms accountability 15 respondents representing 3.4% are Undecided while 331 respondents representing approximately 74.9% agree that a change of auditor after a period of mandate would be perceived by the market as an improvement in the firms accountability

The table also indicated 39.9% of the respondents disagree that change of an auditor has the tendency of increasing firms stock returns, 25.8% of the respondents are undecided about the statement, while 34.3% of the respondents agree that a change of an auditor has the tendency of increasing firms stock returns.

It is also seen from the table that 155 number of respondents representing 35.1% disagree that capital market participants view long tenure as having a favourable impact on audit quality, 114 number of respondents indicating 25.8% are undecided about the statement, while 173 number of respondents representing 39.2% agree that capital market participants view long tenure as having a favourable impact on audit quality.

The table further reveal that 103 number of respondents which represents 23.3% of the respondents disagree that a company that has the policy of audit rotation has a tendency of increasing the number of her shareholders, 114 number of the respondents representing 17% are undecided about the statement, while 264 number of respondents representing 59.7% agree that a company that has the policy of audit rotation has a tendency of increasing the number of her shareholders.

Also, the table reveals that 130 respondents indicating 29.4% of the respondents disagree that shareholders have the tendency of accepting completely the report of a long standing auditor than a new one irrespective of years of experience of the two firms, 63 number of the respondents representing 14.3% of the respondents are undecided, while

55.1% of the respondents agree that shareholders have the tendency of accepting completely the report of a long standing auditor than a new one irrespective of years of experience of the two firms.

CONCLUSIONS

We examined the perception of shareholders on mandatory audit rotation in Nigeria. The regression analysis reveals the existence of a negative relationship between Mandatory Audit Rotation (MAT) and shareholders' confidence. This implies that the rotation of external auditors does not boost the confidence of shareholders in Nigeria. The study agrees with findings of Kaplan and Mauldin (2008) who document that audit firm rotation does not strengthen 'independence in appearance' among investors. However, the study disagrees with the findings of O'Leary and Radich, 1996; Hussey & Lan, 2001; Moody, pany and Reckers, 2006; Gates, Lowe & Reckers, 2007 who recorded that rotation of external auditors enhances shareholders confidence in the audited financial statement.

RECOMMENDATION

Rotation of external auditors does not guarantee auditors independence and audit quality. The study recommends that mandatory rotation of external auditors in Nigeria be revisited. The benefit can only be a perception and not a reality while the cost both implicit and explicit does not favour the very shareholders whom the policy seeks to protect.

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APPENDICES

Table 1: Mandatory Audit Tenure and Shareholders Confidence

S/N		Responses / Percentages					
		SD (%)	D (%)	UN (%)	A (%)	SA (%)	TOTAL (%)
1	A change of audit firm after a period of mandate would be perceived by the market as an improvement in the firms accountability	30 (6.8)	66 (14.9)	15 (3.4)	216 (48.9)	115 (26)	442 (100)
2	Change of an auditor has the tendency of increasing firms stock return	53 (11.9)	124 (28)	101 (23)	135 (26.9)	29 (6.6)	442 (100)
3	Capital market participant view long tenure as having a favourable impact on audit quality	15 (3.4)	140 (31.7)	114 (25.8)	136 (30.8)	37 (8.4)	442 (100)
4	A company that has the policy of audit rotation has a tendency of increasing the number of her shareholders	-(-)	103 (23.3)	75 (17.0)	228 (51.6)	36 (8.1)	442 (100)
5	Shareholders have the tendency of accepting completely the report of a long standing auditor than a new one irrespective of years of experience of the two firms.	24 (5.4)	106 (24.0)	63 (14.3)	203 (45.9)	46 (10.4)	442 (100)

Source: Field Survey (2011)

Table 2: Spearman Rank Correlation

			MATR	SHPERC
Spearman's rho	MATR	Correlation Coefficient	1.000	-.026
		Sig. (2-tailed)	.	.592
		N	442	442
	SHCONF	Correlation Coefficient	-.026	1.000
		Sig. (2-tailed)	.592	.
		N	442	442

Table 3: Probit Logistic Regression for Model 4 (SHPERC)

	Coefficient	Std. Error	z-Statistic	Prob.
MATR	-0.024339	0.054692	-0.445011	0.6563
	Limit Points			
LIMIT_10:C(2)	-2.055266	0.177513	-11.57813	0.0000
LIMIT_11:C(3)	-1.298561	0.142117	-9.137285	0.0000
LIMIT_12:C(4)	-1.044304	0.137900	-7.572933	0.0000
LIMIT_13:C(5)	-0.998968	0.137322	-7.274659	0.0000
LIMIT_14:C(6)	-0.913685	0.136381	-6.699494	0.0000
LIMIT_15:C(7)	-0.759388	0.134881	-5.630071	0.0000
LIMIT_16:C(8)	-0.640424	0.133926	-4.781922	0.0000
LIMIT_17:C(9)	-0.369526	0.132445	-2.790040	0.0053
LIMIT_18:C(10)	0.101529	0.131689	0.770977	0.4407
LIMIT_19:C(11)	0.374504	0.132268	2.831415	0.0046
LIMIT_20:C(12)	0.825825	0.135401	6.099119	0.0000
LIMIT_21:C(13)	1.744530	0.161828	10.78018	0.0000
LIMIT_22:C(14)	2.096050	0.190410	11.00809	0.0000
Akaike info criterion	4.744403	Schwarz criterion		4.873992
Log likelihood	-1034.513	Hannan-Quinn criter.		4.795516
Restr. log likelihood	-1034.612	Avg. log likelihood		-2.340527
LR statistic (1 df)	0.198037	LR index (Pseudo-R2)		9.57E-05
Probability(LR stat)	0.656310			